BUSINESS LAW SECTION

CORPORATIONS COMMITTEE
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TO: Office of Governmental Affairs

FROM: W. Derrick Britt, Vice Chair Legislation
Corporations Committee of the Business Law Section of the State Bar of California

RE: A.B. 2944 (Leno), as amended May 6, 2008

Committee Position:

☒ Oppose

Date position recommended:	June 3, 2008	
Standing Committee vote:	May 2, 2008: 16-0 (with delegation of authority to drafting committee)	June 3, 2008 5-0 with one member unavailable to vote (drafting committee approval of revisions, per delegated authority)
Business Law Section Executive Committee vote:	April 8, 2008: 16-0 (delegation of authority to Legislative Subcommittee)	June 3, 2008: 5-0 (vote of Legislative Subcommittee)
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I. Statement of Position

The Corporations Committee (the "Committee") of the Business Law Section of the State Bar of California (the "Section") welcomes this opportunity to comment upon AB 2944, as most recently amended on May 6, 2008 (the "Bill"). This is the second statement of position that the Committee has submitted on this matter. The Committee continues to oppose the Bill as amended.

A. Description of A.B. 2944.

The Bill seeks to modify Section 309 of the California Corporations Code (the "Code") to expressly provide that directors of a California corporation, in considering the best interests of the corporation, may consider, without limitation, the following factors, to the extent that they deem appropriate: (i) the long-term and the short-term interests of the corporation and its shareholders; (ii) the effects that the corporation's actions may have in the short term or in the long term upon any of the following: (A) the prospects for potential growth, development, productivity, and profitability of the corporation, (B) the economy of the state and the nation, (C) the corporation's employees, suppliers, customers, and creditors, (D) community and societal considerations, and (E) the environment. The Bill insulates directors from individual liability for basing decisions on such factors (without regard to interests of the corporation's shareholders), and provides that directors shall be presumed to be acting in the best interests of the corporation absent a showing of a breach of fiduciary duty, lack of good faith or self-dealing. The Bill mandates that such presumption also apply (and no higher burden of proof be used) to evaluate directors' conduct relating to or affecting a sale (or other acquisition of control) of a California or foreign corporation with significant ties to California, and if such act is approved by a majority of disinterested directors provides that such presumption may be rebutted only by clear and convincing evidence that the disinterested directors did not assent to the act in good faith after reasonable investigation.

B. The Committee's Position.

EXECUTIVE SUMMARY

The Bill seeks to provide directors of California, and possibly non-California, corporations with a legal basis to justify taking actions that may serve the interests of various constituencies relevant to a corporation[1], but which may be inconsistent with the interests of a corporation's

[1] The term "constituents" is popularly used to refer collectively both to groups that have legally-recognized interests in corporations (*e.g.,* shareholders) and to groups that are asserted to have another form of interest (*e.g.,* the community at large, employee, suppliers, customers and creditors). In that sense, the term is often used to assume a legal conclusion: that such other groups have interests that are or should be comparable to the interests of shareholders. That term is used here solely because of its increasing prevalence in popular,

(footnote continued on next page)

shareholders. Absent breach of fiduciary duty, lack of good faith, or self-dealing, directors who consider the interests set forth in the Bill in properly exercising their duty of care shall have no liability based on any alleged failure to discharge their duties as directors. Moreover, as most recently amended, the Bill also seeks to significantly limit the ability of shareholders to challenge actions taken in connection with a sale or acquisition of control of a corporation.

Instead of promoting corporate social responsibility, the Committee believes that the Bill would lead to less director accountability, less responsive corporate governance and, ultimately, less socially responsible corporate behavior, for the following reasons:

- The Bill would undermine director accountability to shareholders.
- The Bill is unnecessary because current law is not an impediment to responsible corporate behavior and there are less intrusive means of protecting the interest of non-shareholder constituents.
- The Bill has the potential for causing significant economic harm to shareholders and the public generally.
- The Bill changes the judicial standard of review applicable to evaluating director actions to approve a sale of a corporation, making it harder for shareholders to protect their interests.
- The Bill creates ambiguity for foreign corporations subject to certain provisions of California law pursuant to Code Section 2115 (often called "quasi-California" corporations) further discouraging companies from being domiciled in California.

The Committee has no objection to formalizing an intention to create benefit for interests and interest groups beyond the traditional interests of shareholders (popularly referred to as "B corporations"); however, the Committee believes it is not proper to attempt to implement such a regime and have it apply to all corporations subject to Section 309. If the legislature believes that the establishment of B Corporations is in the best interests of the corporate community, such provisions should be set forth in a separate section of the Corporations Code which includes appropriate procedural protections, including at a minimum, an "opt in" procedure and unanimous shareholder approval. Instead, the Bill attempts to turn all corporations that are subject to Section 309 into B Corporations without the consent of their shareholders and without appropriate procedural protections to ensure that the shareholders truly understand what factors directors may base their decisions on when acting in the best interests of the corporation.

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non-legal analysis of corporations but should not be construed as a conclusion by the Committee that such external interests do have such rights.

1. Corporate Governance Concerns

The Bill represents a renewed attempt to expand the standard of care for corporate directors to allow them to consider interests unrelated to the best interests of shareholders. As with the Committee's concerns voiced in response to Senate Bill 1528 proposed in 2004 (which contained provisions similar to the provisions proposed in this Bill), the Committee has the following concerns with the current Bill:

- **<u>The Bill would make directors less accountable.</u>** The Bill would modify a longstanding standard of director accountability in California with a rule that would allow directors to invoke reasons for their decisions that are unrelated to the best interests of shareholders. As one commentator has noted, provisions like those contained in the Bill "could leave [directors] so much discretion that [they] could easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer, nor national wealth, only their own."[2] By adding to the universe of interests which directors may consider (even those in conflict with interests of the shareholders, to whom directors owe a duty of care), the Bill is not offering a choice between responsible or irresponsible corporate behavior *but instead is providing another means for directors to escape accountability*. It is important to note that Institutional Shareholder Services, Inc., an influential proxy and corporate governance advisory firm, counts incorporation in a state with non-shareholder constituency provisions like those contained in the Bill as a negative factor when calculating its Corporate Governance Quotient, a well-known standard for measuring the quality of corporate governance.

- **<u>The Bill has the effect of an anti-takeover measure that would entrench directors and management</u>**. Historically, legislation of this type has been enacted in other states for the purpose of adding to the corporate arsenal of anti-takeover devices. In this, the Bill is directly contrary to recent legal trends toward greater shareholder democracy and more responsive corporate governance. Thus, the Bill would serve to entrench directors by giving them defenses against shareholder lawsuits, making it easier for them to escape the consequences of failure to meet their fiduciary duties to shareholders.

- **<u>The Bill establishes no standards, thereby burdening conscientious directors</u>**. While some directors could employ the provisions of the Bill to weaken their accountability to shareholders, conscientious directors would be burdened by the diverse and conflicting interests presented. The Committee questions the efficacy of setting forth numerous factors that cloud rather than clarify the question of

[2] Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001).

what directors should be considering in order to fulfill their fiduciary duties to the corporation and its shareholders. More importantly, the Bill provides a list of several factors for directors to consider, with no guidance as to what weight to give each factor, nor any procedure for deciding among competing factors. It will be up to the courts to interpret the provisions of the Bill in light of the numerous law suits that we believe will proliferate if the Bill is passed. Despite the disclaimer of new duties or causes of action in subsections (e)(1) and (e)(3) of the Bill, the Committee is concerned that litigants will argue the Bill nonetheless creates enforceable rights that non-shareholder constituents can pursue through litigation against directors. Such arguments have arisen in other states with similar statutes.[3] At a time when corporate boards desperately need capable and committed members, this increased potential for liability can be expected to deter qualified director candidates from serving; compounding the corporate governance problems that passage of the Bill will create.

2. Directors' Duty of Care and Corporate Social Responsibility

The Bill seeks to promote corporate social responsibility by taking away the threat of shareholder lawsuits against directors who wish to consider the factors set forth in the Bill, including interests of non-shareholder constituents. The underlying premise for this legislation is that the threat of such suits is currently a significant constraint against the actions of socially responsible corporate directors. The Committee is not aware of any evidence that the current statutory formulation of the duty of care in Section 309 of the Corporations Code is the cause of socially irresponsible behavior on the part of California corporations. Further, the Committee is unaware of any provision of California law that prevents directors adopting socially responsible corporate policies.

The Bill's necessity is further undermined by the fact that there are more effective means available to the Legislature to deal with the interests of employees, suppliers, customers and creditors, the community and societal impact of corporate conduct and environmental protection, including the many laws that are already in effect to address these matters. Part of a board of directors' fiduciary duties to shareholders involves ensuring that a corporation has appropriate policies in place to comply with such laws. The Committee believes that the non-shareholder concerns expressed in the Bill are better protected by existing and future laws focused on the specific conduct of corporations instead of modifying the delicate legal machinery that provides shareholders with the primary means they have of ensuring that the caretakers of their investments faithfully discharge their duties to such shareholders.

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[3] *See. e.g.*, David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 227 (1991); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992).

3. Economic Impact

By deviating from the standard of shareholder primacy in corporate governance, the Bill can be expected to impair the bottom-line profitability of California corporations. This diversion of management's focus from enhancing the investments made by shareholders, together with the uncertain application of the Bill's vague provisions, almost certainly will have the unintended effect of making it more difficult and expensive for California corporations to attract equity and debt investment.[4]

The economic impact of the Bill may lead many entrepreneurs not to incorporate in California, and may lead many California corporations to reincorporate in jurisdictions more hospitable to the concerns of shareholders, such as Delaware. Moreover, as further discussed in Section 5 of this letter, because Section 2115 of the Corporations Code subjects "quasi-California" corporations to Section 309, the Bill could have the effect of further deterring businesses organized as foreign corporations from choosing to locate and do business in California.

4. The Bill Changes the Standard of Review for Sale of Control

In addition to giving directors a broader set of rationales to justify board action that may be inconsistent with shareholder interests, subsection (f) to the Bill seeks to make it more difficult for shareholders to challenge director action taken in connection with a sale or acquisition of control of a corporation, even action involving self-dealing by directors. In so doing, the Bill represents a departure from the trend in Delaware and other states' corporate laws to impose higher or enhanced scrutiny of board actions taken in connection with a sale or acquisition of control, as well as a marked change in the evidentiary standard currently required under California law to rebut judicial deference to board action.

The second sentence of subsection (f)(1) of the Bill provides*: "…In assessing whether the standard set forth in this section has been satisfied, there shall not be any greater obligation to justify, or higher burden of proof with respect to, any act as [sic] the board of directors ... relating to or affecting an acquisition ... than is applied to any other act as a board of directors ..."* This sentence effectively mandates that the business judgment rule – which is a judicial standard of review applied when evaluating directors' actions[5] – shall apply to any act relating to or affecting an acquisition in the same way such standard of review would be applied to evaluate any routine business action taken by directors. Courts in other states, including Delaware, have

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[4] The Committee notes that non-shareholder constituency statutes are routinely listed as risk factors in prospectuses and other disclosure documents for investors.

[5] The business judgment rule operates as a presumption that, when making a business decision, the directors of a corporation acted "on an informed basis, in good faith, and with the honest belief that the action taken was in the best interests of the company." Biren v. Equality Emergency Medical Group, Inc., 102 Cal, App. 4th 125, 136 (2d Dist. 2002). If a claimant fails to rebut the procedural presumption, the business judgment rule operates as a substantive rule of law, and a court may not impose hindsight analysis on the decisions of the corporation's board of directors. Lamden v. La Jolla Shores Clubdominium Homeowners Assn., 21 Cal. 4th 249, 287 (1999).

held that directors have special responsibilities to their shareholders to maximize shareholder value when approving a sale or acquisition of control transaction – in large part because of the potential for directors to act to preserve their own interests at the expense of shareholders' interests. Delaware courts have held that such special responsibilities justify the courts adopting a higher or "enhanced" level of scrutiny when evaluating such action. See Revlon, Inc. v. Macandrews & Forbes Holdings, 506 A.2d 173, 183 (Del. 1986). Although no California court has ruled squarely whether a similar "Revlon" standard would apply to actions of directors of a California corporation relating to a sale of acquisition of control, some California court decisions have indicated judicial receptivity to the approach used in Delaware. See Katz v. Chevron Corp., 22 Cal. App. 4th 1352 (1st Dist. 1994) (applying Delaware law to conclude that directors' defensive actions taken in connection with a possible sale of control must satisfy a higher standard); Kirschner Bros. Oil v. Natomas Co., 185 Cal. App. 3d 784, 795 (1st Dist. 1986) (noting that actions taken by board were inconsistent with its "duty to its equity shareholders to maximize the sale price of the company"). The Bill's proposed rejection of applying a higher standard of review to board actions relating to a sale or acquisition of control is out of step with the trend of Delaware courts (and courts of other states that tend to look to Delaware for guidance on corporate law matters), as well as California judicial decisions.

More significantly, subsection (f)(2) of the Bill provides: *"...any act of the board of directors ... relating to or affecting an acquisition ... to which a majority of the disinterested directors have assented shall be presumed to satisfy the standard set forth in this section, unless it is proven by clear and convincing evidence that the disinterested directors did not asset to the act in good faith after reasonable investigation."* This subsection effectively changes the standard of proof required under existing California law for a shareholder to rebut the presumption of the business judgment rule applied to board actions related to a sale or acquisition of control where the board obtains approval from a majority of disinterested directors. Under current California law, a claimant desiring to challenge a board action of any type must allege specific facts which, if true, would suggest that the directors acted with a conflict of interest, bad faith or a lack of care or information. Lamden v. La Jolla Shores Clubdominium Homeowners Assn., 21 Cal. 4th 249, 287 (1999). Once asserted, the trier of fact can decide the application of the business judgment rule by a preponderance of the evidence. See Eldredge v. Tymshare, 186 Cal. App. 3d 767, 777 (6th Dist. 1986). As drafted, subsection (f)(2) would require a claimant to satisfy a higher "clear and convincing evidence" standard whenever the action being challenged pertained to a sale or acquisition of control. In addition, subsection (f)(2) would limit a claimant to asserting bad faith or insufficient investigation as a basis to rebut application of the business judgment rule (and not factors like self-dealing or other breaches of fiduciary duty). Consequently, subsection (f)(2) will make it much harder for shareholders to challenge director actions in transactions where directors' interests are sometimes most in conflict with those of shareholders.

5. Uncertainty Created by Bill and Interplay with Section 2115

The Bill is ambiguous as to the scope of its applicability to corporations formed under the laws of states other than California. Section 2115 of the Corporations Code subjects certain foreign corporations (often called "quasi-California" corporations) to some of the provisions of the California Corporations Code, based on factors indicating that more than half of its business is conducted in California and more than half of its voting securities are held by shareholders having addresses within California. Section 309 of the Corporations Code is one of the sections of the Corporations Code made applicable to "quasi-California" corporations by Section 2115. Since the Bill amends Section 309 without modifying Section 2115, all of amended Section 309 would apply to such corporations. However, the Bill appears to attempt to make some but not all of the new provisions of Section 309 applicable to California corporations only by referencing "domestic corporations" in certain sections, while referencing "corporations" in other sections. Specifically, subsection (e)(2) provides that the duty of the board of directors, committees of the board, and individual directors under subsections (a) and (b) of Section 309 applies solely to the "domestic corporation". However, subsection (f)(1) refers only to a "corporation". The Committee questions whether this could be construed as having the effect of making subsections (a) and (b) of Section 309 apply solely to domestic corporations, thereby in effect removing Section 309 from the scope of Section 2115. Conversely, subsection (f)(1) of Section 309 purports to prohibit a higher standard of review of board actions taken in connection with a sale or acquisition of control of a "corporation," which suggests that subsection might apply to all corporations irrespective of state of formation. If so applied, a technology company formed as a Delaware corporation with its headquarters and employees in San Francisco, California would be uncertain whether action taken by its board to approve its sale would be subject to the "enhanced scrutiny" standard of judicial review applicable under Delaware law or the lower "business judgment rule" standard required by the Bill.

6. All California corporations should not be subject to the requirements of the Bill

The Committee understands there are some corporations that desire to institutionalize an intention to create benefit for interests and interest groups beyond the traditional interests of shareholders (popularly referred to as "B corporations"). If the purpose of the Bill is to permit such B corporations to memorialize that intention in their governing documents, the proposal should be specifically limited to that purpose so legislators and interested persons can assess the impact and address any comments or concerns on that basis. Any such measure would need to include procedural protections that would require such entities to have consent from all shareholders to dilution of fiduciary duties to them and for prospective lenders (to whom the fiduciary duty may be owed if the company is in a zone of insolvency) to have advance notice of such provision and consent to it before credit is extended. These procedural protections would have to be thought out and enumerated in the Corporations Code. The Committee's opinion is that this standard should not be applied to all California corporations.

II. GERMANENESS

The Committee believes that its members have the special knowledge, training, experience and technical expertise to provide helpful comments on the Bill, and that the positions advocated in this report would promote clarity and consistency in the law and improve coordination between state and federal law in the regulation of corporate disclosure.

III. CAVEAT

This statement is that only of the Committee. The positions expressed herein have not been adopted by the Section or its overall membership or by the State Bar's Board of Governors or its overall membership, and are not to be construed as representing the position of the State Bar of California. There are currently more than 8,800 members of the Section. Membership in the Section is voluntary and funding for its activities, including all legislative activities, is obtained entirely from voluntary sources.

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